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Appraisals for Estate and Probate Predicted to Increase

The need for appraisals for estate and probate purposes is expected to increase. Estimates of the billions of dollars to be inherited by baby boomers are regularly featured in newspapers and the financial press. Much of those assets are in real estate. With the recent popularity of living trusts, and sophisticated tax avoidance methods for affluent individuals, appraisals are needed both for tax planning purposes prior to a property owner's death, and for settling an estate after death.

When appraisals are needed

As an overview, a non-exhaustive list of when an appraisal could be needed is:

1. Sale to a relative
2. Partitioning an estate among the heirs or beneficiaries
3. Sale to a non-relative
4. Prior to listing the home for sale
5. Partial interest (typically income property)
6. Federal or state estate tax returns
7. Gifts and gift trusts
8. Determining the basis for capital gains tax

Who needs the appraisals

1. Attorneys
2. Accountants and enrolled agents
3. Gift trusts
4. Executors and administrators
5. Trustees

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Definitions

- Administrator - person appointed to manage an estate if there is no will
- Alternate valuation date - for federal estate tax purposes, the value of the gross estate six months after the date of death, unless property is distributed, sold, exchanged, or otherwise disposed of within six months, when the value is as of the date of disposition
- Beneficiary - person or organization who is legally entitled to receive gifts made under legal documents such as a trust or will
- Death taxes - Taxes levied on the property of a person who died. Federal taxes are called Estate Taxes. State taxes are called by various names, such as Inheritance Taxes.
- Decedent - the person who died
- Estate tax - tax imposed on the right of a person to transfer property at death (federal and some states)
- Executor - representative named by the deceased in his or her will to handle the decedent's affairs
- Gift - property transferred freely to a person or institution, before or after a death
- Gross estate - the total value of all property in which the decedent had an interest, and is included by the IRS code
- Heirs - persons who are entitled to receive your property if there is no will or other device (legal description)
- Inheritance tax - tax levied on the rights of the heirs to receive property from a deceased person (some states)
- Intestate - without a will
- Living trusts - set up while a person is alive and which remain under the control of that person until death. Used to minimize probate.
- Marital deduction - all property can be passed to a surviving spouse without any tax
- Probate - the process of proving the validity of the will and executing its provisions under the guidance of the appropriate public official
- Taxable estate - assets minus liabilities, excluding property left to a surviving spouse or charity for federal estate taxes
- Testate - a will or other transfer device such as a living trust is left

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- Trust - one person or institution (trustee) controls property given to another person (trustor) for the benefit of a third person (beneficiary)

Who does the appraisals

If there is no estate tax liability, usually because of the marital deduction or the unified credit, often a letter from a real estate agent is used. However, the executor has to have enough nerve to ask for a 'free' appraisal.

If an audit is anticipated, many attorneys and accountants prefer to use a licensed or certified appraiser, plus possibly a second opinion by another appraiser or a real estate agent. An appraiser with superior credentials and methodology and local experience is preferred as the tax court and circuit courts often look to the best appraisal done by the most competent appraiser rather than "splitting the difference."

In California, probate referees are appointed by the probate court and perform real property appraisals for 1/10 of 1% of the value, for example \$300 on a \$300,000 home. They are exempted from the appraisal ethical conflicts by state law. See if your state has a similar situation. They also get appraisal work from trusts.

Low vs. high values

Executors often ask that the value be "kept low," presumably to minimize estate taxes. But the tradeoff is a higher tax basis. If the gross value of the estate is well under \$600,000 and the beneficiaries plan on keeping the property, a higher value to get a larger stepped up basis may be more advantageous. For example, a property is valued at \$300,000, rather than \$275,000, and is sold 5 years later for \$400,000. The taxable gain would be \$100,000 if previously appraised at \$300,000 and \$125,000 if previously appraised at \$275,000.

Many people are unaware of the stepped up basis and are surprised later when they sell the property several years (or more) after inheriting it.

For owner occupied homes there is often justification for a value at the low end. Many are sold "as is," may be subject to probate requirements like overbids in probate court, and need work. There are substantial penalties for significant over- or under-valuations.

Gifts

Whenever there is a gift, the value needs to be determined.

\$10,000 per year can be given to each child as a non-taxable gift. The gifts are usually cash, but can be an undivided interest in real estate. A family limited partnership can be set up to make the \$10,000 per year gifts.

If the person can afford it, there is a one-time \$600,000 gift exemption that freezes the value of the property for estate tax purposes. It is very useful for property that is expected to appreciate. For example, the person owns two properties: a \$600,000 home in a popular upscale neighborhood, and a \$600,000 ranch in a remote area. Assuming the home will appreciate more than the ranch, you can use the one-time gift exemption to freeze the taxable value.

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Charitable remainder trusts avoid capital gains and give the donor a charitable deduction. They're complicated and only apply to property owned free and clear.

Living trusts

These are a popular method of avoiding probate fees and hassles, but don't help avoid estate taxes. Living trusts were formerly used mostly by the wealthy, but have now filtered down to the middle class, and are becoming more popular.

Typically no appraisal is done when the trust is established. Whether or not an appraisal is needed when the person dies depends on how the trust is set up and what is in it. The typical issue is the stepped up basis if the property is not sold. Of course, that's assuming the real property is transferred into the trust before the person dies (funded).

Fractional interests

If a decedent has a fractional interest in real property, typically less than 50% interest, that portion must be valued. The value of the interest is usually less than its pro-rata share. For example, the decedent owns a 10% interest in a shopping center worth \$1,000,000. The value of the interest is less than \$100,000, as they are very hard to sell, with a limited market.

Determine if the interest is fractional before accepting the assignment. Fractional interests are very difficult to value. Either refer them to someone else or take the time necessary to learn how to appraise them from an appraiser with that type of experience. If you plan on doing much estate or probate work, it's probably worthwhile to learn how to appraise them.

Fractional and partial interests are a 'red flag' to the IRS, so be sure the value is as well supported as possible.

Federal estate (death) taxes

If the fair market value of the *gross* estate is over \$600,000 (one person) (1999 NOTE: this limit increases every year), an estate tax return must be filed. Attorneys we spoke with said this often triggers one or more appraisals for each property, as these returns have a very high audit rate. Improper valuations can have high penalties. In community property states like California, if one spouse dies often no return is filed if the total value of the spousal property is under \$1,200,000, although technically a return should be filed.

We couldn't get any statistics on how many executors file estate tax returns, but one tax consultant said only around 2% need to file.

The IRS expects the number of estate tax returns to grow by 7.7 percent annually between 1994 and 2000, according to a recent IRS report.

1992: 70,000 (actual)

1993: 75,000 (estimated)

1995: 87,000 (estimated)

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2000: 126,000 (estimated)

Every Federal estate tax return is hand screened by experienced estate tax examiners to be classified for audit. The overall audit rate is approximately 20 percent for federal estate tax returns, almost 10 times the audit rate for income tax returns.

Tax rates are from a low of 37 percent to a high of 55 percent. A 20 percent penalty applies to overvaluations (trying to get the basis as high as possible) where the correct value or adjusted basis of any property claimed on a return is 200 percent or more of the correct value. An overstatement of 400 percent of the correct value has a 40 percent penalty.

A 20 percent estate tax penalty applies for estate gift tax understated valuations, if the value is 50 percent or less of the correct value. If 25 percent or less of the correct value, a 40 percent penalty applies.

The IRS's examiner's handbook says that they should request copies of appraisals done within five years of the death and copies of listing information on the subject property within three years of the death.

Date of value and retrospective appraisals

The executor can choose either the date of death, or a date six months later for the effective date of valuation (alternative valuation date). Let the executor know which would provide the more appropriate value (higher or lower) if prices are not stable.

Appraisals done as close to the required date as possible are more accurate and reliable than those done sometime later. If challenged by the IRS, a current appraisal is more credible than one done at a later date.

If the property is held in joint tenancy and an estate tax return is not filed, an appraisal may not be done

at the time of the death of the first joint tenant. Later, when the surviving joint tenant (typically the spouse) dies, the estate needs to establish the basis as of the date of the death of the first joint tenant. This may be many years later.

If you're asked to do a retrospective appraisal, be sure you get a high enough fee to justify the time and risk. Your value will be less reliable than a current appraisal and can be more easily challenged by the IRS. Accurate data on the subject, comps, and the market at that time may be difficult to obtain.

Executors and administrators

The executor sometimes needs values to partition an estate. For example, the decedent has two children, one gets the house and the other gets the stocks, but the estate is to be divided equally between them.